
REPORT OF THE BLUE RIBBON PANEL ON MASSACHUSETTS PUBLIC EMPLOYEES' PENSION CLASSIFICATION SYSTEM

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* The recommendations in this Report have not been reviewed or approved by the staff or directors of the Public Employee Retirement Administration Commission and therefore may not necessarily reflect the views of the organization.

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EXECUTIVE SUMMARY

The Senate and House Chairs of the Joint Committee on Public Service appointed a Blue Ribbon Panel to examine the Commonwealth's public employees' group classification system. This system places every job into one of four categories. On the whole, the higher the group, the more generous the pension benefit. The four groups are roughly based on the following job descriptions:

- Group 1: Officials and general employees.
- Group 2: Employees with job titles presumably reflecting hazardous duties.
- Group 3: State police officers.
- Group 4: Fire fighters, police officers, and some correction officers.

The Panel is aware of the broader debate about whether the Commonwealth should have a defined benefit or defined contribution plan. The Panel believes that it is valuable to have a system where the employee does not bear all the investment risk and where sufficient benefits are paid in the form of a lifetime income rather than a lump sum. The Panel is also aware that Massachusetts public employees pay a high share of their retirement benefit cost, higher than many private sector workers. But the Panel does not address the fundamental issues of plan structure because it has been asked to focus on one component – namely the classification issue.

The classification issue is significant and important. Today the system is perceived as unfair to both public employees and taxpayers because some – particularly those employed by the State with political influence – have the ability to “game” the system. And one of the most frequent approaches to gaming is lobbying for classification into a higher group, with its more generous benefits. Whatever changes are made to the system in the long run, it must function in as fair and rational way as possible today.

The Panel has two sets of recommendations regarding classification: 1) Short-run recommendations for immediate implementation, and 2) Long-run recommendations for new hires. Underlying both sets of recommendations is the presumption that public employees' total compensation (pay and benefits) should be comparable to that paid in the private sector or in other states. The pension should be used as a mechanism for providing retirement income, not as a politically expedient way to increase total compensation.

The Panel recommends that the following changes be implemented as soon as possible:

1. Pro-rate pensions for public employees on the basis of tenure in each Group, rather than on the basis of last job. That is, if an employee works 25 years in Group 2 and 5 years in Group 4, the benefit would be calculated on the basis of the time spent in each group. This change may make people more willing to accept administrative positions after having been in Group 4, and it will prevent windfalls for people who have only short service in higher groups.
2. Amend Chapter 32 to require that individual reclassification requests be filed with the employee's retirement board. Individuals dissatisfied with the board's classification should be able to appeal to the Contributory Retirement Appeal Board (CRAB) and if dissatisfied should follow the established appeal process. No individual requests for reclassification should be entertained by the Legislature.

3. All requests to the Legislature for group reclassifications should be accompanied by a price tag that shows the impact of the reclassification on the retirement system's unfunded liability. Increases in the unfunded liability due to reclassification should be amortized over three years rather than over the remainder of the funding period. In addition, a system should be established for charging any costs related to reclassification of workers back to the employing entity, just as current compensation is now charged.
4. When groups of employees petition the Legislature for amendments to Chapter 32 that would change their classifications, the Public Service Committee should require an opinion of the affected retirement board as to the appropriate classification and a justification for the change based on the criteria set out for each group.
5. The criteria for movement to Group 4 should be based on job responsibilities – not job title.
 - a. The basis for classification to this group should be: i) the daily physical exertion of the job makes it impossible to safely and effectively carry out the functions beyond a certain age, AND ii) given the skills required for their jobs and the numbers of such employees, workers with these responsibilities are unlikely to find suitable alternative employment in the public or private sector.
 - b. Training, certification, and exposure to hazardous substances should be reflected in compensation, NOT in movement to a higher group.
6. The criteria for movement to Group 2 should also be based on an argument that the current position is too demanding to be sustained until age 65 AND that sufficient alternative jobs do not exist for workers with the skills that are exercised in current jobs.
 - a. Again, training, certification, and exposure to hazardous substances are NOT justification for movement to Group 2. These aspects of employment should be compensated through higher pay.
 - b. In light of the erratic history of reclassifications, it would not be considered an adequate basis for reclassification that some group doing similar work is currently in Group 2.
7. The Legislature should place a moratorium on considering all reclassification bills until the classification procedure and criteria are clarified. The job of clarifying the criteria should be delegated to PERAC, with the ability to call on the expertise of the Commonwealth's Human Resources Division and other agencies with knowledge of job characteristics.

For the long run, the Panel recommends the following system for new hires:

1. The current 80 percent replacement wage target is reasonable, given that the public employees are not covered by Social Security.
2. The system should have only two groups:
 - a. Given the enormous improvements in health, life expectancy, and education, most Massachusetts employees should be able to work productively until age 65.

- b. An earlier retirement age should be available for Fire, Police, and those Corrections Officers, whose jobs involve significant daily physical exertion AND, given the skills required for their jobs and the numbers of such workers, are unlikely to find suitable alternative employment in the public or private sector.
- 3. As in the short-term recommendations, benefits should be pro-rated over the number of years in each group.
- 4. Earlier ages for full pensions should be reflected in higher contribution rates. An explicit decision should be made of how those higher contribution rates should be divided between employee and employer. Thus, employee contributions should no longer be based on date of hire as under current law.
- 5. Finally, unlike under the current system, contributions for existing employees should be allowed to vary over time to reflect economic and demographic developments. To provide some predictability, however, the Panel believes that the contribution rates for employees should remain constant for about ten years.

The Panel believes that fixing the classification system is crucial to making the Commonwealth's retirement income system transparent and fair. The Panel urges the Legislature to adopt the proposed changes.

1. THE PROBLEM

The Commonwealth of Massachusetts' public employee retirement system provides appropriate benefits for long-service employees and is on a path toward adequate funding. But the system and the law governing it has grown in spurts over time and incorporates a number of anomalies and inequities. The Senate and House Chairs of the Joint Committee on Public Service appointed a Blue Ribbon Panel to address one component of particular concern – namely, the group classification system.

The specific charge to the Blue Ribbon Panel was to examine the Commonwealth's group classification system in order to improve parity in the program and to protect the integrity of the state's public employee retirement system.¹ The Panel met six times as a group and, in addition, heard testimony from State and local employees at a public meeting on May 10, 2006. This meeting elicited many of the arguments heard over the past year by the Committee on Public Service.

Classification Issues

The Commonwealth's public employee retirement system is defined by four different groups of members. When originally created, these groups were based on the then current understanding of life expectancy of employees in different professions. The current enumeration of those covered by the different groups, however, lacks a well-defined rationale. As a result, the group classification system presents a number of problems for retirement boards, the Legislature, and participants.

A common complaint about the group classifications is that jobs with similar characteristics are not treated in a consistent fashion, leading participants to feel that they are being treated unfairly. A lack of consensus on the rationale for the different classifications adds to this confusion and makes it very difficult for the Legislature to determine whether a request for reclassification should be granted or not. The lack of an agreed upon rationale also contributes to the impression that decisions are made on the basis of political influence instead of merit.

At the public hearing held by the Blue Ribbon Panel on May 10, 2006, participants offered several reasons for having workers in some groups treated more favorably in the retirement system.²

- Persons in hazardous jobs should be allowed to retire younger with full benefits because it is dangerous for them and the public to continue working when they are older. For example, a 55 year-old firefighter's reduced strength and agility due to age would prevent him from doing the job as well as a younger firefighter.
- A second rationale is that the hazards of their jobs shortened their life expectancy and therefore they would not be able to collect benefits as long as workers in less hazardous jobs if they did not retire earlier.

¹See Appendix A for the complete charge to the Panel and Appendix B for biographies of Panel members..

²These arguments mirror those heard by the Committee on Public Service, see Appendix C.

- A third rationale is that the risks of the job require that the person be compensated at a higher rate and the pension benefit is part of the compensation.

Without an agreed rationale for the different group classifications, it is difficult to determine what jobs should be in which group or even if a justification exists for the different groups. An outgrowth of the lack of agreed upon rationale is the many anomalies in the system.

- The Middlesex Sheriff's Office testified that individuals with the same duties but different job titles were placed in different group classifications.
- An electrician with the Worcester Housing Authority testified that he was in Group 1 but electricians doing similar work but employed for the City of Worcester are in Group 2.
- Workers at a 911 call center testified that individuals working in the same room, doing the same job, but with different titles were in different Group classifications.

A second problem in the classification system that contributes to the sense of inequity is that classification and benefits for public employees are determined by job classification at the time of retirement. There is no system for pro-rating benefits according to the years spent in each group classification. Thus, employees have a very strong incentive to move to a higher job classification at the time of retirement or to have their job classification shifted at the time of retirement. By doing so, they reap the benefits of a higher retirement pension even though they may have worked very few years in the higher classification. The lack of pro-rating also makes it difficult to recruit experienced public safety people up through the ranks to managerial positions that are in lower group classifications.

A third problem is the lack of accountability between the decision to place an individual or a group of employees in a higher group and the fiscal impact of that decision on the retirement fund. An employee's and the state or local contribution levels are not related to the group they are in (except in the Group 3 State Police). The contributions from Group 1, 2, and 4 employees go into one pool with no mechanism that connects the payment of higher benefits to the need for higher payments into the retirement fund. Since the public funding for the retirement funds comes from the general budgets for the state or local governments, the employing entity has no financial interest in whether the group is placed in a higher classification and in fact may prefer a higher classification to paying more in salary that would come out of its budget.

Finally, the procedures for changing from one group to another are cumbersome and confusing. Currently, individual petitions are filed with their retirement board at the time of retirement. The State Board of Retirement has procedures for deciding these petitions, but the procedures do not lay out the criteria upon which the petitions will be decided beyond the current language of the applicable statutory section and the body of case law interpreting group classifications. If the petition is denied, the individual may seek an administrative appeal of the decision or petition the legislature for a change of category. Group reclassifications are filed with the Legislature as changes to Massachusetts General Laws Chapter 32. The result is that the Public Service Committee is inundated with requests for reclassification each year.

The Panel's Approach to the Classification Issue

- The Panel is aware of the broader debate about whether the Commonwealth should have a defined benefit or defined contribution plan. The Panel believes that it is valuable to have a system where the employee does not bear all the investment risk and where

sufficient benefits are paid in the form of a lifetime income rather than a lump sum.³ The Panel is also aware that Massachusetts public employees pay a high share of their retirement benefit cost, higher than many private sector workers. But the Panel does not address the fundamental issues of plan structure because it has been asked to focus on one component – namely the classification issue.

- In terms of considering classification issues, the Panel adopted two perspectives – changes to the classification system that were desirable but would need time to implement and changes that could be implemented relatively quickly. In this context, the Panel distinguished between changes that would affect current employees and changes that would apply only to new hires.⁴ The Panel was extremely reluctant, as a matter of equity and fairness, to suggest changes that would significantly alter benefits expected by current employees.⁵
- The Panel also recognized that costs are an important issue, especially given that the system has not yet reached an optimum level of funding, notwithstanding that it is on a path towards this level. (Under current strategy, this level will be reached in 2023 for the state system and 2028 for the local systems.) The Panel's recommendations were not made for the purpose of saving money, and some may cost money. The Panel's focus was instead to propose a system that was more transparent, rational, and equitable. Cost implications should be calculated, and recommendations should be implemented in a cost neutral manner or with identification of additional funding sources if needed.

³ Retirees can always turn lump-sum payments into flows of income through the purchase of a commercial annuity. Retirees, however, rarely purchase annuities with their accumulations, and commercial individual annuity contracts are viewed by many as expensive due to the substantial marketing costs and the tendency for long-lived individuals to purchase these contracts.

⁴ The Panel recognizes the disadvantages of treating current and future employees differently. First, limiting reforms to new hires is an extremely slow way of changing the system. Second, it locks in some of the inequities that are already in the system. On balance, however, the Panel concluded people's expectations of retirement should not be changed midstream in a radical way.

⁵ On the other hand, it is impossible to reform the system without affecting some people's expectations. For example, if two people are in similar positions and one has used the current system to move to a higher group and the second person cannot because the legislature modifies the current system, that action produces a change in expectations.

2. OVERVIEW OF THE CURRENT SYSTEM

Massachusetts public employees are covered by a defined benefit pension plan that is administered by 104 local retirement boards, the Massachusetts State Retirement Board, and the Massachusetts Teachers Retirement Board. The Public Employee Retirement Administration Commission (PERAC) is responsible for the regulation and oversight of all boards and all the systems are governed by Chapter 32 of the Massachusetts General Laws. As shown in Table 1, the system now includes more than 300,000 active workers and about 180,000 retirees.

Table 1. Participants in Massachusetts Public Employee Retirement System

System	Participants	
	Active	Retired
State*	83,178	50,593
Teachers**	88,027	42,164
Local***	138,200	86,000
Total	309,405	178,757

Source: Personal communication with James R. Lamenzo, PERAC, Actuary.

* As of 1/1/06.

** As of 1/1/05.

*** Based on date of most recent valuation which varies by system.

The system is funded by a combination of employee contributions, investment returns, and state or local funding. Employees' contribution rates are based on the date they joined the system (see Table 2). The State began to raise the employee contribution rate during the 1970s, but the Supreme Judicial Court ruled that the rate was part of a contract so that rate hikes were limited to new employees.⁶ The rate for new hires has been raised repeatedly so that contribution rates within the system now range from 5 percent to 12 percent, depending on the date of hire.

Table 2. Contribution Rates in Massachusetts Public Employee Retirement System

Date of Hire	Contribution Rate
Pre-1945	0%
1945-74	5%
1975-78	7%
1979-83	7% + 2 % over \$30,000
1984-96	8% + 2 % over \$30,000
1996-present	9% + 2 % over \$30,000
Teachers under "Retirement Plus"	11%
State police hired after 7/1/96	12%

Source: Commonwealth Actuarial Valuation Report. 2005.

⁶ *Opinion of the Justices*, 364 Mass. 847 (1973).

As a result of the substantial contribution rates, most Massachusetts public employees end up paying for the bulk of their pension benefits. As shown in Table 3, on average those in Group 1 are projected to pay for 74 percent of their retirement benefits, and the average across all groups is projected to be 68 percent. These percentages will inevitably increase as low contribution employees retire and are replaced by those hired under the new higher rates. For some new hires, their contributions will more than cover their pension benefits.⁷

Table 3. Employee Contributions as a Percent of Total Normal Cost for the State Retirement System as of January 1, 2006

Group	Total Normal Cost	Expected Employee	Employer Normal Cost	Employee Contributions as a Percent of Total Normal Cost
Group 1	11.2%	8.3%	2.9%	74.1%
Group 2	12.7	8.1	4.6	63.8
Group 3	21.2	8.6	12.6	40.6
Group 4	19.8	8.9	10.9	44.9
All	12.3	8.3	4.0	67.5

Source: James R. Lamenzo, PERAC, Actuary

The share of retirement benefits paid directly by Massachusetts public employees significantly exceeds that paid by the typical private sector worker, who is covered by Social Security and an employer-sponsored 401(k) plan. (In the private sector, a 401(k) plan is the sole retirement vehicle for nearly two-thirds of employees with employer-sponsored pension coverage.) The private sector employer contributes 6.2 percent to Social Security and typically pays 3 percent in the form of a 401(k) match on the employee's 6 percent contribution.⁸ As a result, private sector workers end up paying only 57 percent of the cost of their total retirement income compared to 68 percent for the average Massachusetts employee currently in the system.⁹ And, as noted above, this comparison will become less favorable over time as more Massachusetts employees pay higher contribution rates.

⁷ This is likely to occur for some Group 1 employees who are contributing at the 9 percent rate and who do not retire with a disability benefit, according to James R. Lamenzo, PERAC, Actuary.

⁸ The most common match in a 401(k) plan is 50 percent of the employee's contribution up to 6 percent of earnings, which produces an effective employer match rate of 3 percent of earnings. See Profit Sharing/401(k) Council of America, *48th Annual Survey of Profit Sharing and 401(k) Plans* (2005).

⁹ This example excludes any consideration of health care benefits.

At the local level most classification occurs at the date of hire as set out in state law. With the exception of the State police, State level classification occurs when employees announce their plans to retire.¹² At that time, they inform the State Retirement Board and request to be placed in a certain group. The Board's Classification Committee reviews the requests and makes a determination. Based on the current language of the statute and governing case law, classification is then based on the most recent position that the employee has held for 12 calendar months. That is, an employee requesting Group 2 or Group 4 status must show that he has been employed in that capacity for 12 months, and his agency must certify his position and duration of employment. If the Classification Committee has no issues, it will approve the request. If the Classification Committee does not agree with the request, the claim is submitted to the State Retirement Board. The Board's Classification Committee reviews 30-50 cases per month and approves a large majority. It takes issue with only 10-20 percent of the cases.

People who want to change their individual status or the status of everyone with similar job titles might take their case to the Legislature. For example, if social workers asked to be put in Group 2, they might be denied by the State Retirement Board. At that time, the social workers might then file legislation to be included in Group 2. Last year the Public Service Committee considered 124 bills regarding classification and benefit levels, of which 61 were to move a group of employees into a higher classification, 7 were to enrich the benefits of a specific individual, and the remaining bills primarily dealt with petitions for enhanced benefits for various groups. The lack of clear criteria to decide which individuals or groups should be in Group 2 or 4 other than the job titles listed in the statute makes it difficult for both the retirement boards and the Public Service Committee to address these petitions.

Individuals who switch to a higher group for the last few years of work, or even the last 12 months, will get a benefit calculated as though they were in that group classification for their entire work history and conversely, employees who switch to a job with a lower group classification will lose the higher benefit associated with the higher group.

¹² The Supreme Judicial Court in the case of Maddocks v. Contributory Retirement Appeal Board & State Retirement Board, 369 Mass. 488 (1976) ruled that the group classification provisions within G.L. c.32 indicated a legislative intent that the classification be based on current job requirements at the time of retirement. As such the Court held classification was properly based on the sole consideration of job duties at the time of retirement. Additionally, state employees frequently move between positions, making the classification at hire irrelevant for group determination at time of retirement.

3. LONG-RUN RECOMMENDATIONS REGARDING CLASSIFICATION

The Panel concluded that the most effective way to devise recommendations for dealing with current employees was to consider what an ideal defined benefit system should look like for new employees. The Panel decided on the following eight criteria.

1. For the Commonwealth, a good retirement plan should help attract and motivate a talented labor force and should have a reasonable and reasonably predictable cost. A retirement plan is NOT a good substitute for adequate wages or for adequate benefits for disabled workers or survivors of deceased workers.
2. For employees who spend their entire careers working under the Massachusetts Retirement System, a good pension plan should provide an adequate retirement income and allow benefits to start at a sensible retirement age.
 - a. Adequacy is conventionally approached by considering how much of pre-retirement earnings should be available after retirement, referred to as a replacement rate. The current 80 percent replacement wage target is reasonable, given that the public employees are not covered by Social Security.
 - b. For those spending only a portion of their careers working under the system, a good plan should make a suitable contribution toward an adequate retirement income.¹³
3. A sensible retirement age is when employees, because of age, are no longer able to adequately and/or safely perform their jobs AND have no reasonable expectation of suitable alternative employment.
 - a. Training, certification, and exposure to hazardous substances should be reflected in compensation, NOT in retirement age.
 - b. Job characteristics, not job titles, should be the basis for classification.
4. Given the enormous improvements in health, life expectancy, and education, most Massachusetts employees should be able to work productively until age 65
 - a. Employees in highly stressful jobs, such as social workers or 911 dispatchers, should have paths to move to less demanding positions within the public or private sector when exhausted by their current job.
5. An earlier retirement age should be available for Fire, Police, and Corrections Officers, whose jobs involve significant daily physical exertion AND, given the skills required for their jobs and the numbers of such workers, are unlikely to find suitable alternative employment.

¹³ A suitable contribution to retirement income is not necessarily proportionate to length of service. Traditionally, plans like the Commonwealth's, which have sought to encourage workers to stay in their employment long-term, have viewed a suitable contribution as less than proportionate to length of service. More recently, concern has increased over attracting and retaining productive workers who may not view their jobs as career jobs. This concern might argue for a review of the relationship between the accrual of pension benefits and length of service. An analysis of an optimum pattern of benefit accrual was beyond the scope of the Panel.

6. An earlier retirement age might also be appropriate for other groups who claim that the hazards of their job shorten their life expectancy at age 65. At this point, however, the panel has seen no data to support this claim, and therefore does not make any recommendation on this point.
7. Earlier ages for full pensions should be reflected in higher contribution rates. An explicit decision should be made of how those higher contribution rates should be divided between employee and employer. Thus, contributions should no longer be based on date of hire as under current law.
8. Finally, unlike under the current system, contributions for existing employees should be allowed to vary over time to reflect economic and demographic developments. Employees would be told when hired that their contribution rates would be adjusted over their period of employment. To provide some predictability, however, the Panel believes that the contribution rates for employees should remain constant for about ten years. Re-establishing the rates each decade will enable the system to maintain the desired balance between employee and employer contributions.¹⁴

In summary, the Panel recommends the following system for new hires:

- The current 80 percent replacement wage target.
- Two groups of employees:
 - Most Massachusetts employees receive full benefits at 65.
 - An earlier retirement age for those whose jobs involve significant daily physical exertion AND, given the skills required for their jobs and the numbers of such workers, are unlikely to find alternative employment.
- Benefits pro-rated over the number of years in each group.
- Contribution rates differ by job classification, not date of hire.
- Employee contribution rates adjusted every ten years.

¹⁴ However, the nature of the Commonwealth plan is such that employer contributions are necessarily subject to adjustment for short-term gains and losses, such as those arising from unexpected investment results. These adjustments mean that a constant ratio between employer and employee contributions will never be exactly realized.

4. SHORT-RUN RECOMMENDATIONS REGARDING CLASSIFICATION

With agreement on the recommendations for the long run, the Panel then set out a set of recommendations that could be implemented immediately without undue changes to the expectations of current employees.

1. Initiate a major effort to benchmark State *compensation* (not just wages as appears to be the most common practice at both the state and federal level) against that paid in the private sector and in the public sector in other states.¹⁵ The goal is to make it possible for the state and localities to change compensation in the most effective – rather than the most politically acceptable – fashion.

Discussion: The pension system can be and is used to increase compensation when increases in wages are viewed as politically unacceptable. Having information on compensation should allow the state and localities to make the best choice between alternative forms of compensation that have an equal cost to the employer. The Panel favors periodic evaluations in order to fairly compensate the Commonwealth's employees without putting undue weight on pensions. It is hard enough to design a good pension system to fulfill the purpose of attracting, holding, and motivating workers by providing suitable retirement income without also trying to use the pension system to offset the difficulty of achieving appropriate compensation.

2. Pro-rate pensions for public employees on the basis of tenure in each Group. That is, if an employee works 25 years in Group 2 and 5 years in Group 4, the benefit would be calculated on the basis of the time spent in each group. This change may make people more willing to accept administrative positions after having been in Group 4, and it will prevent windfalls for people who have only short service in higher groups.

Discussion: Presently, State and local workers can gain retirement benefits under a higher group with only 12 months of service. That is, a worker could be in Group 1 for 29 years, switch to a Group 2 job for the last year, and have his entire 30 years of service credited at Group 2 accrual rates. The panel viewed this treatment as unfair. In addition, some employees refuse to accept promotion to managerial positions because they would have to switch to a lower group. For example, it is difficult to get fire fighters to teach at the fire academy because they would lose their Group 4 status.

The Panel considered three options for implementation of a pro rata classification system, applying it to all current employees, applying it only to current employees who change job classification after the date a pro rata system is implemented, and applying it to only those hired after the pro-rata provision is implemented. The Panel recommends that it be applied to all those changing job classifications after implementation. The Panel recognizes that everyone would have to be placed in a job classification at the time of implementation. The Panel also recognizes that some employees had expectations of switching jobs to higher groups as part of their career path. For those employees, pro-rating will involve a change in expectations. Nevertheless, the Panel viewed pro-

¹⁵ Exceptions to the common practice of focusing on wages alone are California and Colorado. California has undertaken the *Total Compensation Survey*, at the recommendation of the California Performance Review, to learn about total compensation including pension plans and health care to help the State employers "make fiscally sound business decisions about its employee compensation policies." The results of the first survey were released in April of 2006. (See California Department of Personnel Administration. 2006. *Total Compensation Survey*.) Colorado conducts an Annual Compensation Survey similar to the *Total Compensation Survey* to gather data to ensure an "integrated and prevailing compensation package." (See Colorado Department of Personnel and Administration. 2005. *Annual Compensation Survey Report Fiscal Year 2006-2007*.)

rating as an important reform to eliminate gaming, encourage mobility within public employment, and provide a fairer pension system.

The question also arose as to whether the system has the data needed to calculate benefits on a pro-rated basis. The Panel concluded that if data were a problem, the system should put the resources into collecting the required information.

3. Chapter 32 should be amended to require that individual reclassification requests be filed with the employee's retirement board. Individuals dissatisfied with the board's classification should be able to appeal to the Contributory Retirement Appeal Board (CRAB) and if dissatisfied should follow the normal appeal process. No individual requests for reclassification should be entertained by the Legislature.¹⁶

Discussion: The procedures to change an individual's classification are unclear and confusing. The State Retirement Board has tried to rationalize the procedure on its own, but legislation codifying a clear procedure would provide a standardized procedure and make the steps more transparent.

4. All requests to the Legislature should be accompanied by a price tag that shows the impact of the reclassification on the retirement system's unfunded liability and designates the funding source for any cost increases. Increases in the unfunded liability due to reclassification should be amortized over three years rather than over the remainder of the funding period (with a goal of 2023 for the State system and 2028 for the local systems). And a system should be established for charging any costs related to pension plan reclassification of workers back to the employing entity, just as current compensation is now charged.

Discussion: The system involves inadequate financial accountability. Sponsoring units often fail to recognize that the movement to a higher group involves a cost to the system. Requiring a price tag and specifying the funding source will highlight the cost associated with the proposed changes and improve accountability. Making employing entities accountable is one key to reducing the request for reclassification.

5. When groups of employees petition the Legislature for amendments to Chapter 32 that would change their classifications, the Public Service Committee should require an opinion of the affected retirement board as to the appropriate classification and a justification for the change based on the criteria set out for each group.

Discussion: The procedures to change a group's classification are confusing. The recommended procedures should make the steps more transparent.

6. The criteria for movement to Group 4 should be based on job responsibilities – not job title.
 - a. The basis for classification to this group should be: a) the daily physical exertion of the job makes it impossible to safely and effectively carry out the functions beyond a certain age, and b) given the skills required for their jobs and the numbers of such employees, workers with these responsibilities are unlikely to find suitable alternative employment within the public system.

¹⁶ The Panel recognizes that there is no way to preclude future use of the legislative process to establish reclassification. However, the Panel urges that it be acknowledged as the "sense of the Legislature" that such future use should be avoided.

- b. Training, certification, and exposure to hazardous substances should be reflected in compensation, NOT in movement to a higher group.
- 7. The criteria for movement to Group 2 (which would exist for current employees, but not new employees) would also be based on an argument that the current position is too demanding to be sustained until age 65 AND that sufficient suitable alternative jobs do not exist for workers with the skills that are exercised in current jobs.
 - a. Again, training, certification, and exposure to hazardous substances are NOT justification for movement to Group 2. These aspects of employment should be compensated through higher pay.
 - b. In light of the erratic history of reclassifications, it would not be considered an adequate basis for reclassification that some group doing similar work is currently in Group 2.
- 8. The Legislature should place a moratorium on considering all reclassification bills until the classification procedure and criteria are clarified. The job of clarifying the criteria should be delegated to PERAC, with the ability to call on the expertise of the Commonwealth's Human Resources Division and other agencies with knowledge of job characteristics.

5. NON-CLASSIFICATION ISSUES FOR FURTHER CONSIDERATION

During the Panel's deliberations, several topics emerged that the panel judged to be beyond the scope of its charge from the Joint Committee on Public Service, even though some topics interacted with the classification system. Nevertheless, it was felt that these topics warrant further review in the future and thus are mentioned here for the edification of the reader.

1. Vesting

For workers employed for only part of their career in public employment, a good retirement system should make a reasonable contribution to retirement income. Massachusetts' 10-year vesting requirement means that many workers leave public service with little more than their own contributions.¹⁷ In addition, crediting service on a pro-rata basis, as Massachusetts does, means that part-time workers may not be vested for 20 years.

Recommendation: Consider lowering the vesting requirement for retirement benefits (not health benefits) to five years and credit 1,000 hours of employment in a 12-month period as one year of service for vesting purposes as is required in the private sector under the Employee Retirement Income Security Act (ERISA).

2. Pre-retirement Earnings

A key issue is how to measure pre-retirement earnings. Currently benefits are based on the average of the last three years base earnings, with no adjustment for inflation or average earnings growth over those three years. Both the use of such a short period for measuring pre-retirement earnings and the lack of an adjustment for inflation are not consistent with a well-designed retirement system.¹⁸ Reliance on only three years of earnings may generate benefits that do not reflect lifetime living standards, gives larger benefits to those enjoying rapid earnings growth at the end of their careers – typically those with higher earnings, and invites employees to manipulate positions toward the end of a career to game the determination of benefits.

Recommendation: Establish a group to consider basing benefits on average lifetime earnings (indexed to reflect the growth of prices or wages over the employee's career), and adjusting the accrual rates so as to keep the total benefit costs constant.¹⁹

3. Post-retirement Inflation Adjustment

Currently, the Massachusetts Retirement System provides a cost-of-living adjustment on the first \$12,000 of benefits. The adjustment is limited to the increase in the consumer price index or 3 percent, whichever is less. Even low inflation rates after retirement can seriously erode the purchasing power of benefits since many retirees will live for a long time in retirement.

¹⁷ Employees who leave public service with less than five years of service receive a refund of their contributions with no interest. Those who stay between five and ten years receive a small amount of interest.

¹⁸ As one point of contrast, in calculating benefits Social Security upgrades past earnings based on the growth of average earnings from when they were earned until shortly before benefit eligibility (referred to as indexing earnings) and bases benefits on the best 35 years of these indexed earnings. The final three year average calculation is common in private sector defined benefit plans but tends to reward those with the most rapidly rising earnings profiles.

¹⁹ As long as benefits are based on only three years of earnings, employees holding two simultaneous jobs can game the system. To limit the possibility of gaming, the pension should be based solely on the earnings from the longest-held job.

Recommendation: Consider applying a full cost-of-living adjustment (instead of a maximum of 3 percent) to the entire benefit (instead of simply the first \$12,000). This can be done while holding cost constant by having a lower initial benefit along with a larger inflation adjustment.

4. Retirement Age Flexibility

A good pension system needs to recognize that different retirement ages may be appropriate for different workers, even if they hold the same kind of job. In addition a good pension plan should not unduly alter the trajectory of a worker across different jobs, both within employment by the Commonwealth and to other employers. Similarly, it should not unduly encourage or discourage retirement once a sensible retirement age has been reached. In order to meet these criteria, the present discounted expected value of retirement benefits should not change greatly when retirement benefits are delayed beyond the earliest time at which they can be claimed. That is, foregone benefits should result in a benefit increase afterwards that roughly offsets the value of the foregone benefits.

Recommendation: Consider changing the benefit accrual rate so that employees who postpone claiming benefits at 65 receive an increase in their benefit amount and participants retiring before age 65 receive benefits that are appropriately reduced to reflect expected lifetime payments as well as retention considerations.²⁰

5. Interaction of Age and Service

The interplay between age and service in the formula used in the Massachusetts public pension system (the formula is: final average salary multiplied by years of service multiplied by the age factor) results in a substantially higher reward for a year of service by an employee who continues to work until the targeted retirement age than for a year of service by an employee who leaves at mid-career. Modifications in the plan design can shift the benefits to favor work at younger ages, but any modification will have pros and cons for different groups.

Recommendation: The Legislature (or some other body) should establish a commission to study the advantages and disadvantages of different rates of benefit accrual over the employee's work life and to make recommendations to the Legislature for any changes.

6. Sustainability

In designing a long-lasting retirement plan, it is important to remember that the health of older workers will continue to improve across cohorts and the life expectancy at any given retirement age will also continue to increase across cohorts. In determining benefits and contributions, the Massachusetts system currently does not recognize that life expectancy and therefore lifetime benefits will increase in the future. For example, future increases in longevity might trigger both a modest increase in the target retirement age and in the contribution rate.

Recommendation: Consider developing a mechanism that would adjust contributions and/or benefits in order to keep them in a suitable relationship to each other.

²⁰ Benefit accruals before age 65 should probably be somewhat smoother than they are currently.

7. Social Security

In Massachusetts, public employees do not pay into the Social Security system and do not receive any retirement benefits from Social Security as a result of their Massachusetts public service. In recognition of this, the Massachusetts public pension system operates with higher contribution rates and payouts.

Social Security is currently running a long-term deficit. Many proposals to restore balance include a provision for mandatory coverage of all (newly hired) state and local workers. Accommodating the integration of Social Security and the Massachusetts pension system would be a major challenge.

Recommendation: Should Social Security coverage be mandated, undertake a major study to explore the design of an integrated system. The new system would inevitably be a somewhat less generous, supplementary program, since Social Security would provide the base of support for Massachusetts public employees.

8. Health Care

Dramatic increases in health care costs for retirees and current employees provide a major fiscal challenge for governments and all other organizations for that matter. An increasingly higher percentage of State and local budgets goes towards funding these costs on a pay-as-you-go basis. Beginning after December 15, 2006, Governmental Accounting Standards Board (GASB) Statement 45 will require governments to account for liabilities for current and future retirees on their balance sheets. While Statement 45 does not require pre-funding of health care liabilities, the disclosure will put pressure on government employers to more fully fund these costs. More full funding of health care costs could slow the pace of funding the pension plans.

Recommendation: To control long-term health care costs, consider altering the link between eligibility for retirement income benefits and eligibility for health care, and relate the Commonwealth's contribution for health insurance to years of service.

9. Costs of Buy-backs

"Creditable service" bills allow members of the retirement system to "buy back" years of service. Those who buy back creditable service generally pay the amount into the system that would have been deducted at the time of their employment plus "buy-back interest." This interest is half the actuarially assumed interest rate, which varies by system in Massachusetts.

For former employees, who have withdrawn their money from the retirement system, and return to state service, the buy-back provision makes sense. For this group, the issue is how to fairly calculate interest for contributions remaining in the system or what interest must be paid if buying back into the system. For employees whose previous service was not with the state, bills giving groups or individuals creditable service for time in the Peace Corps, out-of-state teaching, or other activities, may lack a clear public purpose, while increasing the demands on the retirement fund.

Recommendation: Establish a study group to assess the costs and merits of the current buy-back system.

APPENDIX A

Charge to the Blue Ribbon Panel on the State's Retirement Group Classification System from Senator Patricia Jehlen and Representative Jay Kaufman, Chairs of the Joint Committee on Public Service

The Commonwealth's retirement system is defined by four different classes of retirees. When originally created, these classes were based on the then-current understanding of the life expectancy of employees in different professions. However, the current enumeration of those covered by the different classes is a patchwork that defies rational understanding. The Committee on Public Service hears hundreds of bills each session that propose to move individuals or groups of employees from one class to another. Many of the proposed moves make sense if looked at in isolation, but were we to say "yes" to each, we'd put the financial integrity of the state system in jeopardy. In any event, it is hard to find an organizing rationale in the listing of individuals or groups currently in the four classes, and, thus, hard to rely on precedents for today's – or tomorrow's – decision making. Moreover, it appears that, over time, the promise of enhanced retirement benefits has in some, if not many, cases been used as a substitute for adequate pay. We fear that this reliance on the unforeseeable future distorts hiring decisions and career choices, even while compromising the viability of the state's pension system.

To protect the integrity of the state's pension system, to restore parity to the system, and to guide retirees and lawmakers going forward, we ask you to examine the state's classification system, compare it to other public and private systems, and make recommendations for its reform.

Specifically:

- What and how many classes should there be?
- What should be the distinctions between and rationales for them?
- What groups of employees should qualify for each and how should the benefits of each be defined to assure fairness and sustainability?

We ask that you hold at least one open meeting to hear concerns and recommendations from the public in general, public employees and the organizations representing them and retired employees in particular.

We ask you to list, but reserve for another day and another panel, any other questions about our pension system that may arise in the course of your proceedings.

We request your report and recommendations by June 15, 2006, and are deeply grateful for your service on this panel.

APPENDIX B

Blue Ribbon Panel on the Massachusetts Public Employees' Pension Classification System Panel Member Biographies

Alicia H. Munnell, Panel Chair

Director of the Center for Retirement Research at Boston College

Alicia H. Munnell is the Peter F. Drucker Professor of Management Sciences at Boston College's Carroll School of Management and serves as the Director of the Center for Retirement Research at Boston College. Dr. Munnell spent 20 years at the Federal Reserve Bank of Boston, where she became Senior Vice President and Director of Research. She left the Boston Fed in 1993 to become Assistant Secretary of the Treasury for Economic Policy, and then moved to the President's Council of Economic Advisers. Among many other affiliations, Dr. Munnell was co-founder and first President of the National Academy of Social Insurance. She is a member of the American Academy of Arts and Sciences and the Institute of Medicine and is on the Board of the Wheeling-Pittsburgh Steel Corporation, The Century Foundation, the National Bureau of Economic Research, and the Pension Rights Center. Dr. Munnell received her Bachelor's degree from Wellesley College, her Master's degree from Boston University, and her PhD from Harvard University.

Ellen A. Bruce

Director of the Pension Action Center at the University of Massachusetts at Boston

Ellen A. Bruce is the Associate Director of the Gerontology Institute of the University of Massachusetts Boston. She is an attorney with thirty years experience in the field of elder law. At the University, she developed and now directs the Pension Action Center that includes the New England Pension Assistance Project and the National Pension Lawyers Network. The Pension Action Center represents individuals with employer retirement plans and has recovered over \$27 million for residents of New England. Ms. Bruce has served on numerous boards and task forces relating to health care, retirement benefits, and elder issues. She is a graduate of Wellesley College and Northeastern University School of Law.

Edward E. Burrows

Independent consulting actuary and President of the College of Pension Actuaries

As an independent consulting actuary, Edward E. Burrows has been active in all aspects of employee benefits since 1954. He is an Enrolled Actuary and a past President of the American Society of Pension Actuaries. His awards include the Harry T. Eidson Founder's Award for service to the private pension system (1995), the Jarvis Farley Award for service to the actuarial profession (1998), and the John Hanson Memorial Prize for a paper entitled "Fixing the Pension Plan Funding Rules" (2004).

Joseph Connarton

Executive Director, Public Employee Retirement Administration Commission (PERAC)

Joseph Connarton was appointed Executive Director of the Public Employee Retirement Administration Commission (PERAC) on September 14, 1999. As PERAC's Executive Director, he is responsible for planning, organizing, and executing all administrative and regulatory functions in conformity with the policies and directives of the Commission and in accordance with the mandates of the Massachusetts Legislature. Prior to his appointment as Director of PERAC, he also served as the Managing Director for a New England Regional law firm, managing and directing the representation of client interest in connection with proposed legislation and/or regulation. Mr. Connarton is a graduate of the University of Massachusetts at Boston and received his Masters degree from the John F. Kennedy School of Government at Harvard University.

Peter A. Diamond

Professor of Economics, MIT

Professor Peter A. Diamond began his teaching career as an assistant professor of economics at the University of California at Berkeley in 1963 and was there until 1966, when he joined the MIT faculty as an associate professor. He was promoted to professor in 1970. He was head of the MIT economics department from 1985-86, held the John and Jennie S. MacDonald Professor of Economics chair from 1989-91, and in 1991 he was selected to hold the first Paul Samuelson Professorship in Economics. He became an Institute Professor in 1998. In 1998, Professor Diamond was named co-chair of a panel convened by the National Academy of Social Insurance to study proposals to privatize Social Security. He served on the Senate Finance Committee's Panel on Social Security Financing in the mid-1970s and on panels of technical experts consulting to the President's Advisory Councils on Social Security. He received a Bachelor's degree in mathematics summa cum laude from Yale University in 1960 and his Ph.D. degree in economics from MIT in 1963.

Scott Harshbarger

Senior Counsel, Proskauer Rose LLP and former Attorney General

Mr. Harshbarger has served as national President and CEO of Common Cause, Attorney General for the state of Massachusetts, Middlesex County District Attorney, among other positions of leadership. Mr. Harshbarger served as the Massachusetts Attorney General from 1991 to 1999. During this time, he was elected president of the National Association of Attorneys General after serving as vice president of the same organization. Scott Harshbarger's lengthy career in public service includes experience as a prosecutor, regulator and public advocate, providing him with the expertise to provide counsel and strategic legal advice to CEOs, general counsel, trustees, public officials, and other boards of governance on such matters as fiduciary responsibilities, governmental inquiries, fraud investigations, and crisis management. Mr. Harshbarger is a graduate of Harvard College and Harvard Law School.

Elizabeth K. Keating

Lecturer on Law, Harvard Law School

Elizabeth K. Keating is a Lecturer at Harvard Law School and a Senior Research Fellow at the Hauser Center for Nonprofit Organization. She is also affiliated with the Center for Business and Government's Regulatory Policy Program, and the A. Alfred Taubman Center for State and Local Government. Her research focuses on nonprofit and governmental accountability, retirement savings as well as financial distress. She has taught accounting at the Kennedy School of Government, Kellogg School of Management at Northwestern University, Stern School of Business at New York University, and the Not-for-Profit Institute at Columbia University. Prior to becoming an academic, Keating ran a consulting firm serving nonprofit organizations and worked as a credit officer and research analyst on Wall Street. She is a CPA and received her Ph.D. in management from the Sloan School of Management at MIT and her MBA from the Stern School of Business at New York University.

Alan G. Macdonald

Executive Director, Massachusetts Business Roundtable and former member, Winchester Retirement Board

Alan G. Macdonald is Executive Director of the Massachusetts Business Roundtable (MBR), a not-for-profit organization of seventy-five leading executives of major Massachusetts enterprises. MBR's mission is to focus the management perspective of its members on statewide issues to help the Commonwealth's public leaders design and implement policies that benefit the state's economy and quality of life. Prior to coming to MBR in January of 1989, Mr. Macdonald served for ten years as the Manager of State Government Relations for General Electric Company in Massachusetts and in other New England states. Prior to his work with GE, he was Manager of Government Relations and Public Affairs for Gulf Oil Corporation in New England, Pittsburgh and Washington, D.C. From 1969 to 1975, Macdonald was an Assistant Attorney General for Massachusetts, working primarily in the areas of environmental law and criminal law enforcement. Macdonald is a graduate of Dartmouth College (1966) and Boston College Law School (1969).

APPENDIX C

Families of Arguments Made for Reclassification *Prepared by the Joint Committee on Public Service*

Each session, the Committee on Public Service hears more than a hundred bills to move individuals or groups of employees from one class to another. Most of the plaintiffs argue that a particular job has a higher level of danger or stress than other jobs in its current group, that employees with similar jobs and responsibilities should be united in the same group, and/or that reclassification is a matter of equity.

Some employees argue that they should be transferred to a different group based on the risks of their employment. For example, employees of the Department of Social Services have requested to be moved from Group 1 to Group 2. The employees and their representatives argue that their job subjects them to a higher level of danger and stress than a typical Group 1 job. DSS employees often go to a home to remove children from their parent's custody. During a removal they are often subjected to threats and physical acts of violence. They argue that many times they require police protection in order to go into a home and that this higher level of danger should qualify them for Group 2 status. Water and Sewer workers contend that they should be moved to a new group because they are subject to hazardous material and chemicals during their careers. They provide testimony and documentation about the materials and chemicals they encounter but no data showing that this exposure causes any effects.

Some employees argue that they should be treated like other employees with similar positions and responsibilities. For example, the UMASS police are currently in Group 2. They argue that they should be in Group 4 since police officers that serve in cities and towns are Group 4 and UMASS police are full police officers who have received the same training as city and town officers. Police at UMASS also argue that they are responsible for a large campus with more people at one time than many of the cities and towns. Emergency dispatchers make a similar argument to be included in Group 2. Depending on what title is applied to a 911 dispatcher they may be classified as Group 1 or Group 2. Often employees doing the same job in the same department are classified in different groups.

Some constituencies argue that the Legislature should eliminate Group 1 entirely and place every Group 1 employee into Group 2. Group 1 employees have to attain age 65 before they reach the highest actuarial factor of 2.5. Most Group 1 employees contribute to the pension system for more years than Group 2, 3, or 4 employees. Newly hired Group 1 employees must contribute at a 9 percent rate with an additional 2 percent for all salary over \$30,000. At this rate it is argued that a Group 1 employee will contribute more than the value of his pension over his time of service, with the state not contributing any additional funds. No actuarial data has been provided in support of this argument but it is generally acknowledged that a Group 1 employee pays far more for their pension than employees in the other Groups (see Table 3 in text).